Pass-Through Entities Not Left Out of Tax Reform

By Tim Thomasson and Don Carpenter

This article is the second in a series of articles examining the major changes to the tax code resulting from the new tax reform bill. In this article, we will address the Qualified Business Income (QBI) deduction available for business conducted in pass-through entities, including any limitations. We will discuss some of the many questions raised by this new tax law which hopefully the Treasury Department addresses in future legislation.

Much discussion of the new tax law has centered around the highly publicized reduction in individual and corporate income tax rates. However, a recent Tax Foundation publication indicated over 90 percent of businesses in the United States operate through pass-through entities. With a reduction in the corporate income tax rate, absent action from Congress, business conducted in pass-through entities would have been at a comparative disadvantage. In fact, after considering the repeal of the 9 percent Domestic Production Activities Deduction (DPAD), owners of pass-through entities may have seen their tax liability actually increase. Congress addressed this issue by temporarily providing non-corporate taxpayers a deduction for 20 percent of qualified business income (the QBI deduction) from a pass-through entity. Absent further action from Congress, the QBI deduction expires for taxable years beginning after Dec. 31, 2025.

To be clear, Limited Liability Companies (LLCs) are a common form of pass-through entity. LLCs are treated for tax purposes as either sole proprietorships, partnerships or S corporations for income tax purposes, depending on the number of owners and any entity classification elections made. Therefore, we have omitted the LLC terminology from this article. The QBI deduction also includes qualified REIT dividends and certain income from publicly traded partnerships. The focus of this article is on traditional pass-through entities.

The QBI Deduction – Reducing the Effective Tax Rate on Pass-Through Earnings

At first glance, the calculation of the QBI deduction appears straightforward. We will use Robert and Mary Smith, a married couple who file a joint return, as an example. In 2018, Robert has $100,000 of taxable wages from his employer. Mary received a salary of $20,000 from Small Corporation, an S corporation in which Mary owns 20 percent. Small Corporation manufactures widgets in the United States. Mary's Schedule K-1 from Small Corporation reflected $90,000 of ordinary business income and $5,000 of taxable interest income. Assume the couple will claim the standard deduction for 2018. In Figure 1, we calculate their taxable income, including the QBI deduction.

We will walk through the calculation of the QBI deduction using the illustration in Figure 1.

Not All Income Qualifies

We calculate the Smiths' QBI deduction as 20 percent of Mary's $90,000 share of ordinary business income from Small Corporation. Note the QBI deduction only applies to Small Corporation's business income, not to her share of interest income from the company or to the salary she received. The new tax law specifically excludes from the definition of QBI most types of investment income, such as interest or dividends, allocated from a pass-through entity.

In addition, QBI does not include reasonable compensation paid by an S corporation to a shareholder. A similar rule applies to guaranteed payments made by a partnership to a partner. Note there is no mention, in the committee reports or in the Act itself, of reasonable compensation in the case of a sole proprietorship and its owner. We will discuss this point in more detail later.

A New Deduction "From AGI"

The Smith's QBI deduction is "from adjusted gross income (AGI)," and is available even though they are claiming the standard deduction. This new deduction from AGI is a rare exception in a tax act that eliminated longstanding above-the-line deductions, such as moving expenses and alimony. Accordingly, the Smiths claim the QBI deduction even though they do not itemize. But because it is a deduction from AGI rather than a deduction to compute AGI, it will not affect the limitation on any deductions determined by AGI, such as charitable contributions.

Not Everyone Benefits

As with many tax benefits, Congress giveth and Congress taketh away. The QBI deduction is no exception. Once a taxpayer's taxable income (exclusive of this deduction) reaches a certain threshold, the benefit from the QBI deduction may be reduced. The threshold for married taxpayers filing a joint return begins at $315,000 and is phased-in over the next $100,000. The threshold for other filers begins at $157,500 and is phased-in over the next $50,000. Unlike many phase-out ranges based on income, taxpayers affected by these thresholds can still fully benefit from the QBI deduction if they do not run afoul of two limitations.

Figure 1.

Robert's salary	$100,000
Mary's income from Small Corporation	
Salary	20,000
Ordinary business income	90,000
Interest income	5,000
Adjusted Gross Income (AGI)	$215,000
QBI deduction	(18,000)
Standard deduction	(24,000)
Taxable income	$173,000

Qualified Business Limitation

As we discussed in calculating the QBI deduction for the Smiths, the QBI deduction is not available for wages received for providing services to an entity nor is it available for most types of investment income. If a taxpayer's income is above the limitation threshold discussed above, the QBI deduction is also not available for income from a "specified service business." In defining a specified service business, Congress looked to the definition used for two other purposes: the IRC Section 1202 partial exclusion on sale of small business stock and the IRC Section 475 mark-to-market rules for dealers in securities. Accordingly, a specified service business is any business involving the performance of services in the fields of:

- health,
- law,
- accounting,
- actuarial science,
- performing arts,
- consulting,
- athletics,
- financial services,
- brokerage services,
- investing,
- investment management,
- trading or dealing in securities,
- partnership interests or commodities, or
- any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its owners or employees.

It is noteworthy, however, that Congress specifically excluded "engineering" and "architecture," both of which are included in the IRC Section 1202 definition, from the prohibited list of services.

In the original example for the Smiths above, we noted that Mary's salary and investment income from Small Corporation did not qualify for the QBI deduction. A determination of whether Small Corporation was engaged in a specified service business was not relevant since the Smiths' taxable income, before the QBI deduction, was not above $315,000.

Assume instead that Robert's salary was $299,000, increasing the couple's taxable income, before the QBI deduction, to $390,000. Since Small Corporation is engaged in the manufacturing and selling of widgets, there is no reduction in the QBI deduction under this limitation, because the business income is not from a specified service business.

But what if Small Corporation provided actuarial services instead? Now, the Smiths QBI deduction is limited since Small Corporation is engaged in a specified service business. The couple's income exceeds the threshold amount by $75,000. Therefore, the QBI deduction is reduced by 75 percent, calculated as $75,000/$100,000. This limitation reduces the Smiths' QBI deduction from $18,000 to $4,500. Had the Smiths' taxable income exceeded $415,000, there would be no QBI deduction.

W-2 Wages and Qualified Property Limitation

The second limitation, which also only applies if income is above the limitation threshold, ties the QBI deduction to the wages and depreciable personal property attributable to the business. Specifically, this limitation caps the QBI deduction at the greater of (1) 50 percent of W-2 wages or (2) the sum of 25 percent of W-2 wages plus 2.5 percent of the unadjusted basis, immediately after acquisition, of qualified property.

W-2 Wages. The W-2 wages include not only the amounts currently taxable to an employee in Box 1 of the Form W-2, but also elective deferrals reportable in Box 12 that an employee makes to 401(k) or similar plans.

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Figure 2. Examples

Let's revisit the Smiths. Remember the Smiths' QBI deduction in our original example is $18,000. If Robert's salary was $324,000, increasing the Smith's taxable income (prior to the QBI deduction) to $415,000, the W-2 wages/qualified property limitation applies.	
Assume the following information from Small Corporation with regards to its wages:	
Total employee wages (including Mary's)	$200,000
Less: employee deferrals to a 401(k) plan reported in Box 12 of W-2	(30,000)
Taxable wages reported in Box 1 of W-2	$170,000
W-2 wages for purposes of the QBI deduction would be $200,000, taxable wages prior to any deferrals elected by the employee. Mary has a 20 percent interest in Small Corporation's income. Her share of W-2 wages would be $40,000.	
Assume further the following unadjusted basis of Small Corporation's property, plant and equipment at the end of the tax year:	
Building (39-year recovery period, placed in service in 2004)	$1,900,000
Land	200,000
Furniture (7-year recovery period, placed in service in 2007)	100,000
Equipment (7-year recovery period placed in service in 2010)	2,500,000
Qualified property would not include the land, which is not depreciable, or the furniture since its depreciable period has now expired. As real property, the building is not included in the definition of qualified property. That leaves only the equipment. Although the recovery period for the equipment has ended, the depreciable period is the longer of the recovery period or 10 years. The depreciable period does not end until 2020. Therefore, the equipment is considered qualified property. It should also be noted that the unadjusted basis does not change over the 10-year period, as it is not reduced by depreciation.	
As a result, the unadjusted basis of qualified property is $2,500,000. Mary's share would be $500,000, or $2,500,000 X 20%.	
The Smiths' QBI deduction cannot exceed the greater of: (1) $20,000 ($40,000 times 50%) or (2) $22,500 (sum of (1) $40,000 times 25% and $500,000 times 2.5%)	
In this case, the limitation does not reduce the QBI deduction and the Smiths can deduct $18,000. However, if Mary's share of W-2 wages were only $10,000, the deduction would be limited to $15,000, calculated as the greater of: (1) $5,000 ($10,000 times 50%) or (2) $15,000 (sum of $10,000 times 25% and $500,000 times 2.5%) There is no carryover of any QBI deduction disallowed by either limitation.	

Figure 3. Examples

What if a Taxpayer Has More Than One Qualified Business? What if Mary Smith also owns a 20 percent interest in Tiny Corporation, an S corporation engaged in a qualified business? For 2018, assume that Small and Tiny Corporations report the following to Mary:		
	Small Corporation	**Tiny Corporation**
Qualified business income	$90,000	$100,000
W-2 wages	10,000	70,000
Qualified property	500,000	600,000
If the couple's income is above the limitation threshold, their QBI deduction is calculated as follows:		
20% of business income	$18,000	$20,000
50% of W-2 wages	5,000	35,000
25% of W-2 wages plus 2.5% of qualified property	15,000	32,500
QBI deduction	$15,000	$20,000
Separate Calculation for Each Qualified Business The Smiths' QBI deduction would be $35,000. The W-2 wages/qualified property limitation is first calculated for each qualified business. This limitation reduces the deduction for Small Corporation from $18,000 to $15,000, but does not reduce the deduction for Tiny Corporation. Note the W-2 wages and qualified property of Tiny Corporation do not impact the calculation for Small Corporation. There would have been no limitation had the Smiths been permitted to consider W-2 wages and qualified property on an aggregate basis.		
Losses Further Complicate the Calculation What if Mary's allocable share from Tiny Corporation was a ($50,000) loss instead of $100,000 income? The QBI deduction attributable to Tiny would be ($10,000), calculated as ($50,000) times 20%. The Smiths' overall pass through deduction would be $5,000, representing $15,000 from Small Corporation less $10,000 from Tiny Corporation. If Mary's allocable share from Tiny Corporation was a ($100,000) loss, the sum of her QBI from all activities would be ($5,000) comprised of ($20,000) from Tiny Corporation and $15,000 from Small Corporation. In this instance, the Smith's combined QBI deduction would be zero. They are required to carry $5,000 forward indefinitely, reducing QBI in future years. The QBI deduction also cannot exceed 20 percent of overall taxable income, before this deduction and certain other adjustments. If the Smiths' only income was Mary's share of business income from Small Corporation, the couple's QBI deduction would be limited by the standard deduction, which reduces taxable income.		

Qualified Property. Qualified property represents depreciable personal property (1) held by the taxpayer at the end of the taxable year and available for use in the business, (2) used at some point in the year in generating qualified business income and (3) still within its depreciable period by the end of the tax year. The depreciable period begins on the date the asset is placed in service and ends on the date that is the later of (1) 10 years or (2) the end of the recovery period allowed for MACRS purposes.

Note that property must be personal and must be placed in service. Accordingly, neither real estate nor property that has yet to be placed in service will benefit a taxpayer when calculating this limitation.

Please see Figures 2 and 3 for examples.

The QBI Deduction Raises Many Questions

As with most complex tax reform, the legislation itself raises additional questions. The Treasury Department is already writing regulations to assist taxpayers with application and compliance issues specifically related to the QBI deduction. However, these regulations may take time and still leave significant issues unresolved.

Exactly What is a Business?

While the Internal Revenue Code uses the term "trade or business" numerous times, it never specifically defines what a business is. The hobby loss rules provide guidance as to what a trade or business is not. The rules for the QBI deduction specifically list certain types of

investment activity that do not qualify as "income" for purposes of the deduction. But what about the ownership of rental real estate? The law itself is not clear. Rental income is not specifically listed as a type of investment income for which the QBI deduction is prohibited. In addition, taxpayers can offset rental expense against rental income in determining AGI, even if the result is a loss (subject to the passive activity rules). This result is analogous to other activities that meet the definition of a business.

Therefore, it appears that rental income should qualify for the QBI deduction. Hopefully, future regulations will provide more clarity. Given that rental activity typically does not include significant, or any, W-2 wages and rental real estate is not qualified property, taxpayers with income above the limitation threshold would likely not be able to claim the QBI deduction.

How Will the Treasury Department Interpret "Principal Asset of the Trade or Business?"

When a taxpayer's income has reached the limitation threshold, the qualified business limitation reduces or eliminates the QBI deduction if the pass-through entity is engaged in a specified service business. While the law refers to several specific examples of a service business, it concludes with a catch-all phrase that includes "any trade or business where the principal asset of the trade or business is the reputation or skill of one or more of its owners or employees." Absent significant guidance from the Treasury Department, and possibly even with such guidance, this vague definition is likely to lead to controversy between a taxpayer and the IRS long after the QBI deduction sunsets. Controversy may also occur when services are a significant component, but not the only component, of a business.

How Do Taxpayers Determine W-2 Wages?

For taxpayers with higher income, the determination of W-2 wages allocable to a qualified business is critical in calculating the amount of the QBI deduction. We discussed W-2 wages in an earlier example. But what if an employer outsources the employer-employee relationship to a third party, such as an employee leasing company? The now-defunct domestic production activities deduction (DPAD), which also contained a limitation tied to W-2 wages, provided some ability to include wages of a third party if state common law treated the employees as those of the taxpayer and not the third party. There are similarities between the DPAD and QBI deduction. Whether a similar process is allowable under the QBI deduction is not clear.

W-2 wages paid to an employee-shareholder of an S corporation are included in the calculation of the W-2 wages limitation. But there is no mechanism to impute a compensation element for a sole proprietor and guaranteed payments made by a partnership to a partner are not considered W-2 wages. Whether this distinction for S corporation wages to an employee-owner was intentional, or something that will be addressed in future guidance from the Treasury Department, remains to be seen.

What is Meant By the "Immediately After Acquisition?"

In calculating the W-2 wages/qualified property limitation, the new tax law references the cost of qualified property "immediately after acquisition." Should taxpayers interpret this terminology to mean future additions, such as a new engine in a truck, would not count as qualified property? A more logical conclusion would be to interpret "immediately after acquisition" for each addition to the asset, as well. Hopefully, future guidance will address this uncertainty.

Should a Pass-Through Claim Bonus Depreciation?

Although pass-through entities do not pay tax, they do make most of the elections that impact the amount of income, gain, loss or deduction allocable to the owners. The new tax bill expanded and extended the deduction for 100 percent bonus depreciation. A taxpayer must elect out of bonus depreciation to opt out of this deduction. Bonus depreciation would lower QBI and the QBI deduction.

At first, this appears to be a timing issue, as income in subsequent years would be higher. However, the QBI deduction sunsets after Dec. 31, 2025. As that date gets closer, pass-through entities may consider electing out of bonus depreciation to preserve as much of the QBI deduction as possible and utilize depreciation against income after the sunset.

Is the Benefit Only Temporary to the Taxpayer?

In addition to a possible sunsetting of the deduction, there is the potential that claiming the deduction may result in less of a deduction or additional income elsewhere in the calculation of current or future year's taxable income. For example, assume that Mary was required to reduce her tax basis in Small Corporation by the QBI deduction. That benefit would be temporary as she would have less basis to absorb future distributions or a larger gain on the future disposition of the entity. While the new law itself is silent, regulations for the DPAD stated that the deduction would not impact the tax basis of a pass-through entity. Absent any further guidance, taxpayers could reasonably expect a similar result with the QBI deduction.

Another area where the QBI deduction could have an adverse offsetting tax implication is passive losses. If the law required a taxpayer to reduce passive income by the deduction, the benefit of the QBI deduction could be offset, at least partially, by a reduction in allowable passive losses. Taxpayers calculated the DPAD after

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"THE CHOICE OF BUSINESS ENTITY IS ONE OF THE MOST CRITICAL DECISIONS IN TAX PLANNING."

applying the passive activity rules. Accordingly, the deduction itself did not cause additional limitation of passive losses. Again, absent any further guidance, taxpayers could reasonably expect a similar result with the QBI deduction.

What is the Optimal Entity Choice Given This New Deduction?

The choice of business entity is one of the most critical decisions in tax planning. The QBI deduction complicates the decision for a variety of reasons.

The QBI Deduction Sunsets after 2025. First, the deduction itself sunsets after Dec. 31, 2025. As a comparison, the reduction in the corporate tax rate to 21 percent is permanent. Of course, Congress could always permanently extend the QBI deduction or could increase the corporate income tax rate. This might encourage owners of pass-through entities to structure their operations with a view to possibly elect C corporation status when and if the deduction sunsets.

S Corporation versus Sole Proprietorship. Absent further guidance, or technical corrections to the law itself, the choice of pass-through entity matters. Consider the discussion above regarding W-2 wages. As noted, there is no equivalent to W-2 wages for compensation to a sole proprietor or partner. Compensation paid from an S corporation to an owner-employee is considered W-2 wages for the purpose of applying this limitation. This discrepancy is a distinct disadvantage for pass-throughs operating as proprietorships or partnerships.

Assume Ted Jones, single, operates a business through a pass-through entity. This business generates $100,000 of income and represents Ted's only source of income. The business has no employees except Ted and no qualified property. In Scenario One, Ted operates the business through a sole proprietorship. In Scenario Two, Ted operates the business through an S corporation, paying himself a salary of $40,000 and leaving $60,000 of business income. Ted's income is well below the limitation threshold. As a result, the absence of W-2 wages for the sole proprietorship does not impact his QBI deduction.

In Scenario One, he is entitled to a QBI deduction of $20,000. However, in Scenario Two, his business income is only $60,000, as W-2 wages from a pass-through entity are not eligible for the QBI deduction. Accordingly, his deduction would only be $12,000. Under these circumstances, Ted receives a larger deduction by conducting his business through a sole proprietorship than an S corporation. However, it is likely his self-employment tax in Scenario One would offset any benefit from a higher QBI deduction.

Now assume Ted has taxable income of $225,000 from other sources. His income is above the limitation threshold and his QBI deduction is subject to the W-2 wages/qualified property limitation. Under Scenario One, Ted's QBI deduction would be zero since the sole proprietorship has no W-2 wages or qualified property. Under Scenario Two, Ted's QBI deduction would be $12,000, which is below the W-2 wages limit. Although his compensation from the pass-through entity is not considered QBI, it does count in calculating W-2 wages of the entity. In this instance, Ted receives a larger deduction by conducting his business through an S corporation rather than a sole proprietorship.

Partnerships versus Other Pass-Through Entities. Initially, it appears that a partnership would be less desirable than a sole proprietorship or an S corporation. Guaranteed payments to partners for services provided are not considered W-2 wages for purposes of the W-2 wages/qualified property limitation. However, these payments are also not considered QBI. Therefore, guaranteed payments reduce QBI while not increasing the wage limitation.

However, partnerships may make special allocations. If certain partners of the partnership can benefit from the QBI deduction and others cannot, proper planning could result in an increase of amounts allocable to eligible partners. Congress apparently was concerned about this issue and has specifically authorized the Treasury Department to issue regulations preventing abusive special allocations.

Material Provisions of the QBI Deduction

Although not exhaustive, this article has focused on the most material provisions of the QBI deduction contained in the new tax bill and the impact on owners of sole proprietorships, partnerships or S corporations. The tax reform law article in the next issue of *Today's CPA* will consider the major changes affecting C corporations. ■

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